

Chapter 2

Literature Review

High capital mobility is a characteristic of a free and open economies of the developed world. In the advanced industrial countries, most capital controls were eliminated in the 1980s, and investors can now freely convert domestic assets into foreign assets without significant administrative barriers (Sachs & Larrain, 1993).

In spite of that, the practice of capital controls remains in place in much of the developing world. With capital controls in place, domestic interest rates need no longer be equal to world interest rates. Nor can households convert foreign assets to domestic assets to domestic money rapidly. The central bank will not sell or buy foreign exchange reserves for this purpose (Sachs & Larrain, 1993).

Chronology of capital control

Capital controls, which have been the most important impediments to market access, have seldom completely eliminated all flows, but they have made international transactions more costly and have eliminated certain types of flows. The general idea was some sort of restriction on capital movement was necessary. On this point, Keynes especially was very clear, "It is widely held that the control of capital movements, both inward and outward, should be a permanent feature of the postwar system' (Hoffmeyer, 1978 p23). Nevertheless, it was finally left to the individual countries to determine capital movements.

In the IMF Articles of Agreement, it gave IMF a mandate to encourage free trade but did not give it jurisdiction over capital controls. "Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in the settlement of commitments..." (Hoffmeyer, 1978). Capital controls were an accepted part of the

international monetary system following World War II (Hoffmeyer, 1978, Hauge, 1987; Goodman and Pauly, 1993). Most industrial countries accepted the convertibility of currency but strongly guarded their right to control short-term capital flows.

With the introduction of the flexible exchange rate regime from the beginning of 1973 onwards, the official attitude towards the use of capital controls has been relaxed. In principle, the transition to a regime of flexible exchange rate allows policy makers more autonomy in monetary policy making and greater freedom of capital movements (OECD, 1982; Jomo, 1998).

The rapid growth of international financial markets and the increasing globalization of production, as evident in the rapid growth of foreign direct investment (FDI) between the late 1970s and the early 1990s, also dramatically reduced the usefulness and increased the difficulties in the application of capital controls (OECD, 1982; Lessard and Williamson, 1987; Dornbusch, 1991). The multinational structures and the deepening of financial markets enable firms to adopt strategies of exit and evasion. They can evade capital controls by changing transfer prices or altering the timing of payments to or from foreign subsidiaries.

Other factors contributing to the reduce usage of capital controls is an institutional one. The major industrial countries like the US and international organizations like World Bank and IMF are strongly promoting global financial liberalization. This has discourage the application of capital controls in today's financial and economic environments.

Trend of capital flows

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There are four major trends of capital flows during the 1970s and 1980s (Goldstein et al, 1991), namely,

- a. Sharp expansion in scale of net and gross capital flows in major industrial countries.
- b. Globalization and integration of offshore and major domestic financial markets due to the progressive relaxation of capital controls as well as the broader financial liberation in industrial countries.
- c. Dominant role of private flows in financing fiscal and current account imbalances for the developing countries in the 1970s and for the industrial countries in both the 1970s and the 1980s.
- d. Similarities between the early 1970s and the late 1980s in patterns of official and private capital flows to developing countries, that is official flows were important for financing the current account deficits of both the net-debtor and non-debtor developing countries.

In the 1990s, private capital flows especially portfolio funds have dominated the international capital markets and created destabilizing effects on economic equilibrium. Although international capital flows can potentially play an important role in improving economic efficiency, the closer integration of major capital markets could subject the world economy to various systemic strains where major financial shocks could be transmitted across global markets (Goldstein et al, 1991; BNM 1997), as evidenced from the recent East Asian currency and financial crisis.

The benefits of capital mobility

The progressive relaxation of capital controls as a result of the broader financial liberalization in the industrial countries has brought about a growing integration and globalization of major offshore and domestic financial markets. It allows many investors (often institutional investors such as insurance companies and pension funds) to diversify their portfolio internationally (Goldsten et al, 1991; Jomo 1998). This diversification has been facilitated by the advancement in computer and telecommunication technologies as well as the proliferation of new financial instruments (BNM, 1997).

Access to the international markets offers some clear-cut benefits by providing additional sources of financing and investments to the domestic economy. (Rivera-Batiz, 1989). The surge in capital flows could be the engine of growth in domestic demand, output and capital stock (Bercuson and Koenig, 1993). As such, most of the developing countries are the major beneficiaries of an integrated international capital market that efficiently transfers resources from capital-rich to relatively capital-poor regions for greater economic performance and efficiency gains. Yet, there was only a mixed evidence of a smooth transfer of resources (Goldstein et al., 1991; Eatwell, 1997).

Various studies had been carried out to verify the effect of capital flows on the economies of the recipient countries. Empirical results from the growth equation suggest that economic growth in region has been most significantly related to export growth and growth FDI (Wahyudi, 1990; Husain and Kwang, 1992). And based on the adoption of the empirical methodology developed by Lee, Rana and Iwasaki (1986), Hussain-Kwang's regression model found the effect of FDI on economic growth has been positive and statistically significant in Asean countries.

The effect

Various other researches have stated that financial innovation, openness to and liberalization of international financial market can impose severe constraints on the behavior of the economy and on the effectiveness of domestic economic policies (Hoffmeyer, 1978; Revira0Batiz, 1989; Goldstein et al., 1991; BNM,1997). For example, if a tight monetary policy was adopted to reduce money supply and increase interest rates, a large part of the effect would be offset by private sector borrowing from abroad. The capital flows have responded to economic fundamentals, official policies and market distortions. The capital flows in the international capital markets can respond to a shock through changes in the prices of the country's financial claim, or through some combination of capital flows and asset price changes.

There are many examples of capital flows which have led to exchange rate movements and thus raised complications for policy makers. The recent East Asian currency crisis is a good example where capital flight has led to a depreciation of the exchange rate and creates disturbances to the real economy of those countries. Dependence on short-term capital flows pose more of a systemic risk (BMM, 1997; Musa, 1998) that can lead to exchange rate and liquidity crisis, where there is sharp reversal of such flows.

Mussa (1998) has pointed out that world capital markets were pushing a large flood of capital into emerging markets that reached an annual rate of US\$400 billion in the summer of 1997, in term of gross flows. After the middle of August 1998, these gross flows reached zero, just died completely. He contended that no country, no matter how soundly managed its economic policies are and how solid its banking system is, can maintain an open attitude towards international capital flows in the face of that type of systemic disturbance.

Therefore, the key to economic performance through debt financing via capital inflows is the ability to channel capital funds into domestic investment, while meeting their commitments on existing external debts and maintaining sound economic fundamentals.

Financial liberalization in Malaysia

In Malaysia, financial liberalization began in the early 1970s and accelerated in 1978 with the freeing of interest rates abandoned and reversed in 1983 (Zainal et al. 1994). Liberalization efforts were resumed in earnest in 1987 as the economy improved, with full deregulation of lending rates only in early 1991.

Malaysia has for a long time maintain a relatively open capital account with liberal exchange controls (BNM, 1997) although restrictions on trade in goods is said to be greater, particularly in the highly protected automotive industry.

In mid-eighties, exacerbated by the recession (1985-86), the government decided to accelerated economic liberalization in Malaysia. Such liberalization policies include various efforts at deregulation and legal reforms to attract foreign investors through the raising of Industrial Coordination Act, 1975 exemption levels and the introduction of the Promotion Of Investment Act, 1986 with various investment incentives; reduced Government spending, reduced taxes, especially in the interest of businesses; deployed more public resources to support private investment; encouraged private enterprises, including privatization; and sought to encourage greater public-private sector collaboration (Salleh and Rani, 1991).

Thus, Malaysia undertook to attract foreign capital, particularly FDI which was necessary to generate jobs and incomes in the post 1985-86 recession era (Sivalingam, 1997). Access to domestic market is made available to capital flows with the further liberalization of exchange control regulations and trade and capital accounts, especially relaxation of investment regulation and foreign ownership for export-oriented investments.

After recovery from the recession in the late-1986, efforts were stepped up to enhance both the breadth and depth of the money market. These efforts include the introduction of the principal dealer system, the issuance of Malaysian Government Securities, the lifting of the limits on interbank transactions in 1992, the two-tier regulatory system in 1994 to encourage consolidation of the banking sector to enable local banks to compete in an increasingly liberalized and globalized banking environment. As a result, the size of money market has increased tremendously, from an average annual transaction volume of RM118 billion in 1980s to Rm597 billion in 1990-1996 (BNM, 1997).

The capital market

In 1990s, government has decided to promote the development of the capital market. These efforts include the establishment of Securities Commission in 1993 to strengthen and streamline the regulatory frame (BNM, 1994) in the Kuala Lumpur Stock Exchange (KLSE); the establishment of national mortgage corporation (Cagamas) to spearhead the development of the bond market; and the establishments of the two rating agencies, namely RatingAgency Malaysia and Malaysia Rating Agency Corporation to promote private debt securities.

The scope of the capital market was further expanded by the government's privatization projects. For example, Telekom and Tenaga had offered foreign investors to participate in the initial public offering by way of tender. Step were also taken to enlarge the supply of domestic funds in the capital market through liberalization of guidelines of selected institutional investors like Employee Provident Fund (EPF), Takaful fund, and Amanah Saham Nasional.